STATE OF MINNESOTA
OFFICE OF HEARING EXAMINERS

FOR THE DEPARTMENT OF COMMERCE - SECURITIES DIVISION

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| In the Matter of the Broker-Dealer's License of Margolis & Co. , Inc. ; the Agent's Licenses of Sam Margolis; John Neuberger; Bernard E. McLaughlin, Jr.; and Kenneth Williams. | ) ) ) ) ) | FINDINGS OF FACT, CONCLUSIONS, RECOMMENDATIONS AND MEMORANDUM |

The above-entitled matter cane on for hearing before George A. Beck, duly appointed as Hearing Examiner in this matter, on January 12, 1977, at 9:30 a.m. in the Hearing Room of the Minnesota Department of Commerce on the Fifth Floor of the Metro Square Building, Seventh and Robert Streets, in the City of Saint Paul, County of Ramsey, State of Minnesota. Testimony was subsequently heard on January 13, 19, 20 and February 10, 15 and March 24 of 1977. The final written brief in this matter was submitted on December 13, 1977.

Thomas R. Muck, Assistant Attorney General, 500 Metro Square Building, Saint Paul, Minnesota 55101, appeared representing the Securities Division. Michael C. Mahoney, Esq., 1908 IDS Center, Minneapolis, Minnesota 55402, appeared representing Margolis & Co., Inc., Sam Margolis and John H. Neuberger. Lawrence R. Commers, Esq., 1400 Radisson Center, Minneapolis, Minnesota 55402, appeared on behalf of Bernard E. McLaughlin, Jr. Alvin S. Malmon, Esq., 1250 Builders Exchange Building, Minneapolis, Minnesota 55402, submitted a post-hearing memorandum on behalf of Sam Margolis.

Prior to the hearing in this matter, a settlement was reached between the Securities Division and Respondent Kenneth Williams.

Witnesses at the hearing included: Bernard E. McLaughlin, Jr., Lewis A. Anderson, Will B. Chase, John Neuberger, Ronald V. Locktu, Bryan J. Mahoney, James D. Wright, James N. Campbell, F. James David, George B. Bonniwell, Richard C. Heimerl, Paul R. Kuehn, and Donald L. Andersen.

Based upon all the testimony, exhibits and briefs herein, the Hearing Examiner makes the following:

## FINDINGS OF FACT

l. Margolis & Co., Inc. ("Margolis & Co.") is currently and was at all times relevant hereto licensed as a securities broker-dealer by the State of Minnesota. Margolis & Co. maintains its offices in Minneapolis and had between 20 and 25 securities agents during 1973 and 1974, which was an increase from four or five agents in 1970. (T. III, p. 33) The firm experienced a net operating loss for the 12 months ending December 31, 1973, and for the 11 months ending November 30, 1974. (Ex. 59, T. III, p. 81)

2. Sam Margolis ("Margolis") is currently and was at all times relevant hereto an officer and director of Margolis & Co. and licensed as a securities agent by the State of Minnesota to represent Margolis & Co. He is Chairman of the Board of Margolis & Co. and the chief officer. (T. III, p. 18)

3. John Neuberger ("Neuberger") is currently and was at all times relevant hereto an officer and director of Margolis & Co. and licensed as a securities agent by the State of Minnesota to represent Margolis & Co. Neuberger joined Margolis & Co. in late 1970. (T. III, pp. 5-6) He was first licensed as a securities agent in 1957. (T. III, p. 5) Neuberger has been president of Margolis & Co. since approximately 1972 or 1973. (T. III, p. 7) As president, Neuberger supervised the firm's registered representatives and the day-to-day operations of the firm, including firm underwritings. (T. III, pp. 13, 35)

4. Bernard E. McLaughlin, Jr. ("McLaughlin") was at all times relevant hereto licensed as a securities agent by the State of Minnesota to represent Margolis & Co. McLaughlin is currently licensed as a securities agent for Craig-Hallum, Inc., a broker-dealer. McLaughlin was first licensed as a securities agent in 1967 or 1968, and was licensed to represent Margolis & Co. from 1970 to approximately April of 1974. (T. I, pp. 21-22)

5. Will B. Chase ("Chase") was licensed as a securities agent by the State of Minnesota to represent Margolis & Co. from approximately 1969 to 1974. (T. II, P. 5) Chase was executive vice-president, compliance officer, and a director of Margolis & Co. at all times relevant hereto. IT. II, pp. 14, 19) Chase first became a securities agent in 1961. (T. II, p. 5) As compliance officer, Chase reviewed the firm's confirmation slips and order tickets on a daily basis. (T. II, p. 20)

Fey Industries

6. Fey Industries, Inc. ("Fey") was incorporated under the laws of the State of Minnesota on May 3, 1968. Fey is the successor to Fey Printing & Plastic Mfg. Co., a sole proprietorship conducted between 1965 and the date of Fey's incorporation by John Fey, the president, treasurer, principal shareholder and a director of the company. Fey is engaged primarily in the business of manufacturing vinyl products for sale through distributors to businesses as advertising specialty items. To a lesser extent, Fey is also engaged in the manufacture of vinyl products for retail sale and in commercial printing. Fey's offices and manufacturing plant are located in Edgerton, Minnesota. (Ex. 31)

7. On August 9, 1973, Fey filed a Notification under Regulation A with the Securities and Exchange Cornission seeking an exemption from federal registration requirements in connection with a proposed offering of 100,000 shares of Fey common stock. An amended Underwriting Agreement and an amended Offering Circular was filed on September 25, 1973. Under the terms of the Underwriting Agreement, Margolis & Co., as the underwriter, agreed to purchase from Fey 100,000 shares of Fey common stock at $2.70 per share. Margolis & Co. was the sole underwriter and was obligated to purchase all of the 100,000 shares. The Offering Circular, which was dated October 5, 1973, set the offering price to the public at $3.00 per share. (Ex. 31; T. III, pp. 38, 43, 48) Neuberger was responsible for

underwritings at Margolis & Co. in 1973 and 1974, and he oversaw the Fey underwriting. (T. 1, p. 33; T. III, p. 36)

B. Margolis & Co. bought 46,975 shares of common stock from Fey on October 24, 1973, and the remaining 53,025 shares on November 9, 1973. (Exs. 32, 33; T. III, pp. 44-45) Margolis & Co. actually began selling Fey stock to the public during the second week of October, 1973. (Ex. 28) A copy of the Offering Circular was mailed to each purchaser of Fey stock. (Ex. 28, T. III, pp. 31-32) Neuberger supervised the sale of the Fey stock and kept track of the number of shares sold. (T. III, pp. 36-37, 42) Margolis & Co. had difficulty in selling the Fey stock to the public. (T. III, p. 43) As of November 8, 1973, Margolis & Co. had sold only approximately 60,000 shares and was obligated to sell approximately 40,000 more shares pursuant to its underwriting agreement. (Ex. 28)

The Anderson Transactions

9. Toward the end of October, 1973, Neuberger asked Bernard McLaughlin for his help in completing the Fey underwriting. (T. I, pp. 26, 44) McLaughlin was able to sell approximately 2,900 shares of Fey to his customers in late October and early November of 1973. (Exs. 28, 94) In addition to selling these shares, McLaughlin also purchased 1,000 shares of Fey for the account of his customer, Lewis A. Anderson ("Anderson"), on October 23, 1973, and a further 6,000 shares of Fey for Anderson's account on November 29, 1973. (Exs. 16, 17; T. I, pp. 35, 37; Ex. 96) Anderson was a vice president and loan officer at Camden Northwestern ("Camden Northwestern") State Bank and was a social acquaintance of McLaughlin's. (T. I, pp. 25-26, 68-69) These two trades had not been authorized by Anderson. (T. 1, p. 98)

10. At the tine that he placed the shares in Anderson's account, McLaughlin intended to borrow the money personally to pay for the stock in an attempt to help complete the Fey underwriting which was not selling well. (T. I, pp. 35-36, 43-44)

McLaughlin did in fact proceed to take out a $3,000 loan on November 28, 1973 and an $18,000 loan on December 11, 1973, from Camden Northwestern State Bank with Lewis Anderson as the loan officer. (Exs. 3, 4, 5, 6; T. I, pp. 59, 104) Anderson's monthly account statements with Margolis & Co. show that the 3,000 shares of Fey were paid for on November 28, 1973 (Ex. 18) , and that the 18,000 shares of Fey were paid for on December 11, 1973. (Ex. 19)

11. In late December of 1973, or early January of 1974, McLaughlin decided that he did not want to be responsible for the notes totaling $21,000. (T. I, p. 50) McLaughlin told Neuberger and Anderson that he wanted to cancel the loan. (T. I, p. 45; T. III, p. 88) Neuberger agreed to personally take out a loan to replace McLaughlin's loans and he signed a note for $21,142.01 on January 8, 1974, at Camden Northwestern with Lewis Anderson as the loan officer. (Ex. 23; T. III, p. 87; T. I, p. 10) The proceeds were then used to satisfy McLaughlin's notes for $3,000 and $18,000 on January 10, 1974. (Exs. 67, 68, 69, 77; T. IV, pp. 53, 56-57; T. I, p. 108)

12. The 7,000 shares of Fey remained in Anderson's account until May 10, 1974. (Exs. 20, 21, 60) Sometime prior to that, McLaughlin advised Neuberger that Anderson was leaving the state and therefore, the Fey shares would have to he removed from his account. (T. III, p. 86) Accordingly, Neuberger transferred the 7,000 shares from Anderson's account to the account of James Campbell, an old friend and customer of Neuberger's in May of 1974. (T. III, pp. 89-90; Ex. 60) Campbell did not pay for the shares. (T. III, p. 89) In mid-May of 1974, Neuberger sold all of the Fey stock in Campbell's account at $4.00 per share (Ex. 28; T. III, p. 95), and Neuberger then paid off his own loan at Camden Northwestern for $21,142.01 on May 15, 1974. (Ex. 24)

The Locktu-Campbell Transactions

13. In early November of 1973, Neuberger discussed with McLaughlin the possibility of finding financing for the purchase

of Fey stock (T. III, p. 81) , and asked McLaughlin to introduce him to Lewis Anderson. (T. I, pp. 30-31) Neuberger, McLaughlin and Anderson subsequently had lunch together at a Minneapolis restaurant and McLaughlin introduced Neuberger to Anderson. (T. I, pp. 30-31, 62, 71) During the lunch, Neuberger asked Anderson if Camden Northwestern would be interested in a referral of some Margolis & Co. customers for the purpose of becoming loan customers. (T. I, p. 69; T. III, p. 53) Anderson had hopes of obtaining the checking account business of Margolis & Co. itself. (T. I, p. 136) At some point, Anderson advised Neuberger that funds would be available. (T. I, p. 111)

14. Subsequently, Neuberger contacted two old friends and customers, Ronald V. Locktu ("Locktu") and James N. Campbell ("Campbell") and recommended to each that they buy 5,000 shares of Fey stock. (T. IV, p. 10; T. V, p. 6) Neuberger told them that money for financing the stock purchase was available from Camden Northwestern, and that the loan could be repaid from the later sale of the stock. (T. I, pp. 57, 63; T. IV, pp. 10, 17; T. V, p. 7) on November 12, 1973, Neuberger purchased 5,000 shares of Fey for both Locktu's and Campbell's account. (Exs. 34, 35; T. IV, p. 8; T. V, p. 6; T. I, p. 56)

15. Although Neuberger solicited the Locktu and Campbell purchases of Fey and executed the transactions himself, he assigned McLaughlin's salesman code letter to the confirmation slips (Exs. 34, 35), which resulted in McLaughlin receiving the commission on both transactions in the amount of $1,250. (Exs. 81, 84; T. VII, pp. 17, 20) Neuberger testified the he did this to give McLaughlin a bonus for his help in completing the Fey underwriting by selling Fey and introducing him to Lewis Anderson. (T. VII, p. 19)

16. Subsequent to the luncheon meeting, Anderson had three or four telephone conversations with Neuberger concerning loans for Margolis customers. (T. I, pp. 31, 70; T. III, p. 62)

Anderson was advised during these conversations of the names of the customers (T. I, p. 128), the principal amount of the loans (T. I, p. 133; T. III, p. 54), and the purpose of the loans. (T. I, p. 97) The customers' eligibility for the loans was also discussed. (T. I, p. 71)

17. On November 12, 1973, Camden Northwestern issued a cashier's check payable to "Margolis Co. for Acct. of Ronald V. Locktu" in the amount of $15,000 signed by Lewis A. Anderson. (Ex. 13A) On the same date, Camden Northwestern issued a cashier's check payable to "Margolis Co. for Acct. of James N. Campbell" in the amount of $15,000 and signed by Lewis A. Anderson. (Ex. 14A) These checks represented the loan proceeds (T. I, p. 88) and were forwarded directly to Margolis & Co. and did not go to Locktu or Campbell. (T. 1, p. 55; T. IV, p. 17; Exs. 13A, 14A)

18. In fact, neither Locktu nor Campbell visited Carden Northwestern or talked to anyone at the bank. (T. IV, p. 12, T. V, p. 7-8) Although a promissory note and a financial statement, both purportedly signed by Locktu were supplied to the bank, (Exs. 9, 61) Locktu did not actually sign the documents. (T. IV, pp. 12, 21) The financial statement for Locktu was inaccurate and listed insurance policies which Locktu did not own. (T. IV, p. 22) Locktu testified that Neuberger told him that he (Neuberger) had signed Locktu's name to the promissory note. (T. IV, p. 29) Locktu first saw the note when he received a copy in the mail. (T. IV, p. 12)

19. A promissory note purportedly signed by Campbell in the principal amount of $15,000 dated December 14, 1973, and a financial statement for Campbell were filed with the bank. (Exs. 11, 73; T. IV, p. 64) Campbell did not actually sign this note. (T. V, p. 8) When Campbell received an audit verification concerning the loan from the bank, he called Neuberger who said he would take care of the matter. (Ex. 72; T. V, p. 11)

2 0 . When Campbell's and Locktu's promissory notes came due (after 90 days) in March of 1974, (Exs. 10, 12) Neuberger dealt with Camden Northwestern to obtain extensions of the loans. (T. V, p. 14; T. III, pp. 63-64) The 5,000 shares of Fey in Locktu's account were sold by Neuberger in March and April of 1974. Neuberger sold 1,0OO shares of Fey from Locktu's account on March 21, 1974, at $3.00 per share, 1,0OO shares on March 26, 1974, at $3.00 per share, and 3,000 shares at $3-1/8 per share on April 11, 1974. All of these shares were sold to the Margolis trading department. (Exs. 47, 48, 49, 50, 51) The proceeds from the sale of the stock in Locktu's account were sent directly to Camden Northwestern from Margolis (Exs. 39, 41, 42) and were used to pay off the $15,000 loan in Locktu's name. (Ex. 10; T. III, pp. 68-69, 80; T. IV, pp. 16-17)

21. The 12,000 shares of Fey in Campbell's account were sold by Neuberger to the Margolis trading department on May 13, 1974, at $4.00 per share. (Exs. 28, 45) A portion of the proceeds of the sale, attributable to the 5,000 block of shares, was sent directly to Camden Northwestern by Margolis (Ex. 44) and was used to satisfy the loan in the principal amount of $15,000 in Campbell's name which was paid on May 15, 1974. (Ex. 12; T. V, p. 9; T. III, p. 69)

The Reger Transactions

22. On December 5, 1973, Will Chase contacted his long-time customer, James Reger, and asked him to buy 2,975 shares of Fey stock. (T. II, pp. 26, 28) Reger told Chase that he did not have the money to buy the stock and Chase replied that he would supply the money. (T. II, p. 28) Chase bought the 2,975 shares of Fey in Reger's name and then proceeded to take the necessary money ($8,925.00) from his own personal savings account to pay for the shares. (T. II, pp. 29, 34; Exs. 27, 29, 30, 89, 90; T. VII, p. 54) The 2,975 shares of Fey were the number of shares remaining to be sold in order to complete the Fey underwriting which would then enable Margolis & Co. to obtain its underwriting fee and to begin trading Fey

stock as a market maker. (T. II, pp. 35-36) Chase regarded himself as the real owner of the stock purchased in Reger's name and the stock was, in fact, sold when Chase decided to do so. (T. II, pp. 32, 39)

23. On February 7, 1974, 1,700 shares of Fey were sold from Reger's account at $3.00 per share and on February 15, 1974, 1,275 shares were sold from Reger's account at $3.00 per share. All of the shares were sold to the Margolis & Co. trading department. (Exs. 28, 29, 30) A check for $8,923.00 was sent to Reger on February 25, 1974. (Ex. 91) Reger than wrote a personal check dated February 28, 1974 to Chase in the same amount. (Ex. 92)

24. Subsequent to the completion of the Reger transaction, Margolis & Co. began trading Fey stock as the sole market maker on approximately December 6, 1973, at a quoted price of $3.00 to $3-3/4 per share. (Exs. 63, 66; T. IV, pp. 47-48) The first trade was December 10, 1973. (T. IV, p. 44; Ex. 65; T. III, p. 115) The price quoted by Margolis & Co. and supplied to the local over-the-counter market quotation sheets was at $3-1/4 to $4 on March 19, 1974, $3-1/2 to $4-1/4 on April 10, 1974, $3-7/8 to $4-3/8 on April 16, 1974, $4 to $4-1/2 on April 23, 1974, and $4-1/4 to $5 on May 10, 1974. (Ex. 66; T. IV, p. 50) Margolis & Co. sold stock from its inventory at these increasing prices. Almost all of the sales were solicited. (Ex. 28). Fey stock was not listed on any stock exchange (T. III, p. 43), nor did it appear on the OTC margin list of the Board of Governors of the Federal Reserve System. (T. I, pp. 8, 10)

25. Although Margolis & Co. maintained a compliance manual (T. III, p. 51), McLaughlin had never seen it. (T. I, p. 66) The firm had no method of checking on what its salesmen told customers. (T. III, p. 50) Neuberger testified that Sam Margolis was consulted about the Fey underwriting often, (T. III, p. 42) and that Sam Margolis was aware of the Locktu and Campbell loans when they were made. (T. III, p. 113)

26. That any of the foregoing Findings of Fact which should properly be termed Conclusions are hereby adopted as such.

Based upon the foregoing Findings of Fact, the Hearing Examiner makes the following:

CONCLUSIONS

1. That the Securities Division gave proper notice of the hearing in this matter; that the Commissioner of Securities has the authority to revoke or suspend the license of a securities broker-dealer or agent or to censure the licensee; that the Securities Division has fulfilled all relevant, substantive and procedural requirements of law or rule.

2. That decision as to the constitutionality of Minn. Stat. sec. 80A.07, subd. l(b)(2) is beyond the authority of the Hearing Examiner.

3. That the Securities Division need not prove specific intent or scienter in order to prove "dishonest or fraudulent practices" under Minn. Stat. sec. 8OA.07, subd. l(b)(7), or in order to prove a "device, scheme, or artifice to defraud' or a "fraud or deceipt" pursuant to Minn. Stat. 8OA.01, or in order to prove a 'manipulative, deceptive, or other fraudulent device or contrivance" under Minn. Stat. 80A.03.

4. That the proper standard of proof to be borne by the Securities Division in a proceeding to censure or to revoke or suspend the license of a securities broker-dealer or agent is proof by clear and convincing evidence.

5. Minn. Stat. 80A.07, subd. 1, provides in part as follows:

> The commissioner ray by order deny, suspend

or revoke any license or may censure the licensee, if he finds (a) that the order is in the public interest and (b) that the applicant or licensee or, in the case of a broker-dealer or investment adviser, any partner, officer or director, any person occupying a similar status or performing similar functions, or any person directlv or in-directly controlling the broker-dealer or invest-rent adviser:

(2) has willfully violated or failed to com-
Ply with any provision of this chapter or a predeces-
sor law or the Securities Act of 1933, the Securi-
ties Exchange Act of 1934, the Investment Advisers
Act of 1940, the Investment Company Act of 1940,
or any rule under any of such statutes, or any
order thereunder of which he has notice and to which
he is subject;

(7) has engaged in dishonest or fraudulent
practices in the securities business;

(10) has failed reasonably to supervise his
agents if he is a broker-dealer or his employees
if he is an investment adviser;

6. Section 11(d) of the Securities and Exchange Act of 1934 ("the 1934 Act") provides as follows:

It shall be unlawful for a member of a national
securities exchange who is both a dealer and a
broker, or for any person who both as a broker and
a dealer transacts a business in securities through
the medium of a member or otherwise, to effect
through the use of any facility of a national
securities exchange or of the nails or of any means
or instrumentality of interstate commerce, or
otherwise in the case of a member, (1) any trans-
action in connection with which, directly or in-
directly, he extends or maintains or arranges for
the extension or maintenance of credit to or for
a customer on any security (other than an exempted
security) which was a part of a new issue in the
distribution of which he participated as a member
of a selling syndicate or group within thirty days
prior to such transaction: Provided, That credit
shall not be deemed extended by reason of a bona
fide delayed delivery of any such security against
full payment of the entire purchase price thereof
upon such delivery within thirty-five days after
such purchase, or (2) any transaction with respect
to any security (other than an exempted security)
unless, if the transaction is with a customer,
he discloses to such customer in writing at or be-
fore the completion of the transaction whether he
is acting as a dealer for his own account, as a
broker for such customer, or as broker for some
other person.

7. That Neuberger violated Section 11(d) in that he

arranged for the extension of credit for his customers Locktu and Campbell to purchase Fey stock.

8. That since Neuberger was president of Margolis & Co. and since Minn. Stat. 8OA.07, subd. l(b) imputes the acts of an officer to the broker-dealer, Margolis & Co. also violated Section 11 (d)

9. That the evidence is insufficient to show that McLaughlin violated Section 11(d) of the 1934 Act.

10. Section 7(c)(1) and (2) of the 1934 Act provides in part:

> (c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer
>
> (1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section. (As amended by Act of August 23, 1935, Sec. 203(a), 49 Stat. 704; and by Act of July 29, 1968, Public Law 90-437.]
>
> (2) Without collateral or on any collateral other than securities, . . .

11. Regulation T promulgated by the Board of Governors (12 CFR sec. 220) provides that (1) a broker or other creditor can arrange only for such credit by others as they themselves might extend to their customers (2) the collateral for the loan must be stock listed on a national securities exchange or stock appearing on the over-the-counter margin stock list published by the Board of Governors. [See, 12 CFR 220.2(d) (e)(f) and (h); 220.3(c)]

12. That Respondent Neuberger violated Section 7(c)(1) and (2) by arranging for the extension of credit to his customers Locktu and Campbell to buy Fey stock since Fey was not listed on any stock exchange and did not appear on the Board of Governor's OTC margin list and in that the loans were made without collateral.

13. That pursuant to Minn. Stat. 80A.07, subd. l(b), Margolis & Co. violated Section 7(c)(1) and (2) of the 1934 Act.

14. That the evidence was insufficient to show that Respondent McLaughlin violated Section 7(c)(1) or (2) of the 1934 Act.

15. That by violating Sections 11(d) and 7(c)(1) and (2) of the 1934 Act, Respondents Neuberger and Margolis & Co. violated Minn. Stat. 80A.07, subd. l(b)(2).

16. That the conduct cited in Conclusions No. 7, 8, 12, 13 and 15 also constitutes a dishonest or fraudulent practice by Neuberger and Margolis & Co. in violation of Minn. Stat. sec. 80A.07, subd. l(b) (7) .

17. Section 10(b) of the 1934 Act provides in part:

> Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

18. S.E.C. Rule lOb-6 (12 CFR sec. 240.10b-6) states:

> (a) It shall constitute a "manipulative or deceptive device or contrivance" as used in Section 10 (b) of the Act for any person.
>
> (1) who is an underwriter or prospective under-writer in a particular distribution of securities, or
>
> (2) who is the issuer or other person on whose behalf such a distribution is being made, or
>
> (3) who is a broker, dealer, or other person who has agreed to participate or is participating in such a distribution, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the rails, or of any facility of any national securities exchange, either alone or with one or more other persons to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right until after he has completed his participation in such distribution; . . . .

19. Minn. Stat. sec. 80A.03 provides:

> It is unlawful for any person to effect any

> transaction in, or to induce the purchase or sale of any security by means of any manipulative, deceptive or other fraudulent device or contrivance, including any fictitious quotation. . . .

20. Minn. Stat. sec. 80A.07, subd. l(b)(7) prohibits a securities licensee from engaging in dishonest or fraudulent practices.

21. That Respondent McLaughlin violated Rule l0b-6 which prohibits a broker participating in a distribution from purchasing

the stock which is the subject of the distribution for any account in which he has a beneficial interest in that McLaughlin borrowed $21,000 which he used to purchase 7,000 shares of Fey for the account of Lewis Anderson.

22. That Neuberger violated Rule 1Ob-6 in that he borrowed $21,000 which was used to repay McLaughlin's loan and therefore, Neuberger purchased the 7,000 shares of Fey which remained in Anderson's account until Neuberger transferred the shares to James Campbell's account.

23. That Compliance Officer Will Chase violated Rule l0b-6 in that Chase purchased 2,975 shares of Fey with his own funds for the account of his customer, James Reger.

24. That Margolis & Co., due to the violations by officers Neuberger and Chase, and pursuant to Minn. Stat. 80A.07, subd. l(b), also violated Rule l0b-6.

25. That the underwriting or distribution of this issue of Fey stock did not terminate until the shares of stock placed in the accounts of Anderson, Locktu and Campbell were sold out of those accounts and then sold by Margolis & Co. to other investors, which occurred sometime subsequent to May 13, 1974.

26. That Margolis & Co. also violated l0b-6 in that it bid for and purchased Fey stock for its own account from December 6, 1973 to May 13, 1974, which activity occurred during the distribution as defined in the preceeding Conclusion.

27. That by violating Rule 10b-6, McLaughlin, Neuberger, Chase and Margolis & Co. therefore violated Section 10(b) of the Act and therefore violated Minn. Stat. 80A.07, subd. l(b)(2).

28. That the conduct of McLaughlin, Chase, Neuberger and Margolis & Co. cited in Conclusions No. 21 through 26 also constitutes a violation of Minn. Stat. 80A.03, which prohibits manipulative, deceptive or other fraudulent devices and a violation of Minn. Stat. sec. 80A.07, subd. l(b)(7), which prohibits dishonest or fraudulent practices.

29. Section 17(a) of the Securities Act of 1933 ('the 1933

Act) provides that:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

30. Section 10(b) of the Securities and Exchange Act of 1934, states in part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the nails, or of any facility of any national securities exchange
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commissioner may prescribe as necessary or appropriate in the public interest or for the protection of investors.

31. S.E.C. Rule lOb-5 (12 CFR sec. 240.10b-5) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material

fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

32. Minn. Stat. sec. 80A.01, states:

> It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:
>
> (a) to employ any device, scheme, or artifice to defraud;
>
> (b) to make any untrue statement of a material fact or to omit to state material facts necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

33. That the "parking" of shares in controlled accounts in the course of a public offering is a fraudulent practice or device within the meaning of Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act, S.E.C. Rule l0b-5, [and, therefore, Minn. Stat. 80A.07, subd. l(b) (2)] Minn. Stat. sec. 80A.01, Minn. Stat. 80A.03 and Minn. Stat. 8OA.07, subd. l(b)(7).

34. That during Fey's distribution, Respondent McLaughlin parked 7,000 shares of Fey in the account of Lewis Anderson which shares he controlled and that Respondent Neuberger, upon taking out a loan to pay for the shares, continued to park the shares, which he controlled, first in Anderson's and then in Campbell's account, all in violation of the statutes and rules cited in Conclusion No. 33.

35. That during Fey's distribution, Neuberger parked 5,000 shares in Locktu's account and 5,000 shares in Campbell's account, which shares he controlled, and that Respondent Chase parked 2,975 shares of Fey during the underwriting in the controlled account of his customer, Reger, all in violation of the statutes and rule cited in Conclusions No. 33.

36. That pursuant to Minn. Stat. 80A.07, subd. l(b), and due to the violations of its officers Neuberger and Chase cited in Conclusion No. 35, Margolis & Co. violated the rule and statutes set out at Conclusion No. 33.

37. That the use of false and misleading statements in an offering circular is a fraudulent practice or device

within the meaning of the statutes and rule cited at Conclusion No. 33.

38. That by failing to disclose in its offering circular that a substantial number of shares were parked in controlled accounts, President Neuberger and Margolis & Co. made false and misleading statements in the offering circular in violation of the statutes and rule cited in Conclusion No. 33.

39. That the unauthorized purchase of stock by a salesman for a customer's account constitutes a fraudulent practice within the meaning of Section 10(b) of the 1934 Act, and Rule lOb-5 [and therefore Minn. Stat. 80A.07, subd. l(b)(2)] and also a violation of Minn. Stat. 8OA.01 and Minn. Stat. sec. 80A.07, subd. l(b)(7).

40. That McLaughlin purchased 7,000 shares for the account of Lewis Anderson without his consent or authorization and therefore violated the statutes and rule cited in Conclusion No. 39.

41. That the evidence and legal authority is insufficient to support a conclusion that Margolis & Co. violated the statutes and rule cited at Conclusion No. 39 by bringing the 17,000 "parked" shares of Fey in Campbell and Locktu's accounts into their inventory at prices equal to or above the offering price.

42. Minn. Stat. sec. 8OA.07, subd. l(b)(10) (quoted in Conclusion No. 5) requires a broker or a broker's officers to reasonably supervise their agents.

43. That Margolis & Co. and Neuberger as president of the firm failed to reasonably supervise the agents of Margolis & Co. in that President Neuberger engaged in the aforementioned violations of law thereby creating a climate at the firm which encouraged the violations by agents Chase and McLaughlin and in that compliance officer Chase was engaged in the violations cited above, and in that Neuberger solicited McLaughlin's assistance in his plan to finance the purchase of Fey stock and

also assumed McLaughlin's $21,000 loan in January of 1974.

44. That the evidence was insufficient to show that Respondent Sam Margolis failed to reasonably supervise the agents in his firm.

45. That each Respondent utilized the means of interstate commerce, namely the United States Mails, in the course of the transactions described herein.

46. That the foregoing Conclusions are arrived at for the reasons set out in the Memorandum attached hereto which is hereby incorporated by reference.

Based upon the foregoing Conclusions, the Hearing Examiner makes the following:

RECOMMENDATION

It is recommended that disciplinary action be taken against Respondents Margolis & Co., Inc., John Neuberger, and Bernard E. McLaughlin.

It is further recommended that the proceeding he dismissed as to Respondent Sam Margolis.

Dated: April 18, 1978.

GEORGE A BECK
Hearing Examiner

N 0 T I C E

This Report is a recommendation, not a final decision. The Commissioner of Securities will make the final decision after a review of the record and may adopt, reject or modify the Findings of Fact, Conclusions, and Recommendations contained herein. Pursuant to Minn. Stat. 15.0421, the final decision of the Commissioner shall not be made until this Report has been made available to the parties to the proceeding for at least ten days. An opportunity must be afforded to each party adversely affected by this Report to file exceptions and present argument to the Commissioner. Parties should contact the Commissioner of Securities to ascertain the procedure for filing exceptions or presenting argument.

sec 77- 008-GB

M E M 0 R A N D U M

Respondents Margolis & Co. and John Neuberger have raised several serious constitutional arguments. They suggest that Minn. Stat. sec. 80A. 07, subd. 1 (b) (2) is an unconstitutional delegation of legislative authority, that such a delegation violates the due process clause of the Fourteenth Amendment, and that since the federal courts have been giving exclusive jurisdiction over violations of Federal securities laws, a state agency may not make this determination. Resolution of the Respondents' contentions requires a determination as to the constitutionality of the state statute. Professor Davis has stated that:

> We commit to administrative agencies the power to determine constitutional applicability, but we do not commit to administrative agencies the power to determine constitutionality of legislation. Only the courts have authority to take action which runs counter to the expressed will of a legislative body. 3 K. Davis, Administrative Law Treatise, sec. 20.04 (1958 and Supp. 1976) Vol. III at p. 74.

The court in Finnerty v. Cowen, 508 F.2d 979 (1974), stated that federal agencies like the railroad retirement board have neither the power nor the competence to pass on the constitutionality of legislative action. See also, 73 C.J.S. Public Administrative Bodies and Procedure, 67 at p. 393. Accordingly, since the agency head is unable to determine the question of constitutionality, the Hearing Examiner likewise lacks the authority.

Each Respondent has contended that the Securities Division must prove scienter or specific intent in regard to its anti-

fraud allegations. This claim is based upon the case of Ernst and Ernst v. Hochfelder, 425 U.S. 185 (1976) ['75-'76.Sec. L. Rep. (CCH) paragraph 95,479]. The Hochfelder case held that in a private action for money damages the plaintiff may have to prove scienter in regard to an allegation of fraud in order to make a recovery. Respondents Neuberger and Margolis & Co. cited the

case of Seaboard Leverage Fund v. Neuberger & Co., '77-'78 Sec. L. Rep. (CCH) paragraph 96,207 (S.D.N.Y. 1977) which is also a private action for damages and follows the Hochfelder rule. The earlier case of Hanly v. s.E.C., 415 F.2d 589 (2nd Cir. 1969) held that specific intent to defraud is irrelevant in S.E.C. enforcement proceedings.

The court in S.E.C. v. Southwest Coal and Energy Company, '77-'78 Sec. L. Rep. (CCH) paragraph 96,257 (W.D. La. 1977) summarized the current state of the law as follows:

> The post Hochfelder decisions have disagreed about the application of scienter to S.E.C. enforcement actions. Two circuit courts have indicated that scienter is not required in an enforcement action. S.E.C. v. Universal Major Industries Corp., 546 F.2d 1044 (2nd Cir. 1976) (dictum); S.E.C. V. World Radio Mission, Inc., 544 F.2d 535 (lst Cir. 1976) Two district courts have decided that the S.E.C. must prove scienter to be entitled to injunctive relief under Rule 10b.5. '77-'78 Sec. L. Rep. (CCH) at p. 92,699.

The court in Southwest Coal determined that the S.E.C. must prove scienter for a 10.b.5. injunction, but not in order to show a violation of Rule 17.a.2.

The court in S.E.C. v. Shiell, '77-'78 Sec. L. Rep. (CCH) paragraph 96,190 (N.D. Fla. 1977) decided that scienter was not a necessary element in an injunctive action under anti-fraud provisions. In the case of A. J. White and Company v. S.E.C., 556 F.2d 619 (1st Cir. 1977) ('77-'78 Sec. L. Rep. (CCH) paragraph 96,087), a case very similar to the instant case, the court observed that whether cr not scienter or willfulness existed, the sanctions imposed were justified given the conduct involved. The S.E.C. has stated that it does not construe the Hochfelder decision as altering the Hanly rule in regard to specific in-

tent in enforcement proceedings. In the Matter of Steadman Security Corporation, '77-'78 Sec. L. Rep. (CCH) paragraph 81,243 at f.n. 33. A review of the cases indicates that the courts appear to be moving toward holding that specific intent need not he proved in enforcement actions, and especially those cases involving a license revocation. Accordingly, it is concluded

that the Securities Division need not prove specific intent in order to prove violations of the anti-fraud provisions listed in Conclusion No. 3.

The Respondents contend that the proper standard of proof is that the Securities Division must prove its allegations by clear and convincing evidence. The Respondents base this contention upon the case of Collins Securities Corp. v. S. E.C. , '77-'78 Sec. L. Rep. (CCH) paragraph 96, 122 (D.C. Cir. 1977) The Collins case involved the revocation of the broker-dealer and investment adviser registrations of Collins Securities Crop. for violation of various anti-fraud provisions of the federal securities laws and in particular, for market manipulation. The court stated that:

> Two elements appear relevant to the standard we should impose here: (1) the type of case (fraud); (2) the heavy sanction (deprivation of livelihood). Given those elements, typical of many S.E.C. cases, and given the type of circumstantial proof on which the S.E.C. most often must rely, it appears to us that the "clear and convincing evidence" standard is the proper standard here; it will require the S.E.C. to reach a degree of persuasion much higher than "mere preponderance of the evidence," but still somewhat less than "clear, unequivocal and convincing' or 'beyond a reasonable doubt".

The Securities Division argues quite strenuously that the Collins decision should not be followed in this case. The Division suggests that it is not binding precedent in Minnesota since it is a federal opinion, that it should not be followed because the holding depends, in large part, on federal case law which prescribes a standard of proof in civil fraud matters that is clearly different than the standard established by Minnesota law, and that the adoption of a standard higher than a preponderance would be bad public policy since it would

frustrate the Division's efforts to ensure high standards of good faith and ethical conduct in the securities industry.

The Division cites two licensing cases in support of its belief that the preponderance standard is applied by other jurisdictions in licensure proceedings. The case of G. H. Miller

and Co. v. U. S., 260 F. 2d 286 (7th Cir. 1958) , rehearing en banc 260 F.2d 295, cert. denied, 259 U. S. 907 (1959), involved the revocation of a registration of a future commission merchant and floor broker. In the Miller case, the court interpreted the phrase, "weight of the evidence" to mean proof by a preponderance or greater__weight of the evidence (emphasis added) . Since the government had proven a prima facie case and there was no evidence in defense, the court concluded that there had been proof by a preponderance or greater weight of the evidence. 260 F.2d at 288. The case of Bernstein v. Real Estate Commission of Maryland, 221 Md. 221, 156 A.2d 657, appeal denied, 363 U. S. 419 (1959), involved the suspension of a real estate broker's license. The Bernstein court noted that a preponderance of the evidence and not "beyond a reasonable doubt" was the proper standard in an administrative case since the case was civil and not criminal in nature. 156 A.2d at 663.

The only body of law in the State of Minnesota in regard to the standard of proof in licensing matters is that involving attorney disciplinary proceedings. In the case of In re Rerat, 232 Minn. 1, 44 N.W.2d 273 (1950), the Minnesota Supreme Court stated as follows:

> The cases recognize that to take away an attorney's means of livelihood is a serious matter; hence, proof of wrongdoing must be cogent and compelling. In re Disbarment of McDonald, 204 Minn. 61, 282 N.W. 677, 284 N.w. 888, supra. In re Application of Smith for Reinstatement, 220 Minn. 197, 200, 19 N.W.2d 324, 326, we said: "An attorney should he disbarred only upon a strong and convincing showing that he is unfit to practice law and that disbarment is necessary to protect the public and to guard the administration of justice," although proof beyond a reasonable

doubt is not necessary. State Board of Examiners in Law v. Dodge, 93 Minn. 160, 171, 100 N.W. 684, 689, where this court said: "While it is not necessary to establish a charge against an attorney at law which will result in his disbarment, beyond a reasonable doubt, yet such a charge is so grave, and the consequences of a conviction so serious, that something more than a preponderance of the evidence --the rule in civil actions--is required. The rule in such a case is that, to justify a conviction, the evidence must be full, clear, and convincing.'

Minn. Rule HE 217(c)(5) provides that the standard of proof is "preponderance of the evidence" unless the substantive law provides a different standard. In light of the decision of the Collins court (and especially in light of the allegations of violations of federal anti-fraud laws in this proceeding), and since the only guidance which the Minnesota Supreme Court has provided in this matter is that of the attorney disciplinary proceedings which establish a standard of evidence similar to that proposed by the Respondents, it is concluded that the substantive law and due process does mandate a standard of clear and convincing evidence.

Such a concept is not entirely without support in the decisions of other jurisdictions. In the case of Willis v. Louisiana Real Estate Board, 146 S.2d 237 (1962), the court, in the course of a de novo review of the facts and law involving the revocation of a real estate license, stated that depriving any individual of the means whereby he earns his livelihood should be done upon the basis of "convincing" evidence.

The burden of clear and convincing evidence does not preclude the use of circumstantial evidence or a reliance on inferences from evidence to reach a conclusion. The Collins court agreed with the S.E.C. that in many instances the use of the inferential mode of reasoning is necessary to prove a violation of the securities laws. The Collins court merely stated that such evidence should then be of a quality as to make the sanctions appear just and reasonable. it does not seem reasonable to draw any distinction between the proper standard in attorney licensing proceedings and in those of other occupations or professions. The adoption of this standard of proof may well lead agencies to a more careful presentation of facts and a more detailed examination of the evidence offered.

The Securities Division proved by clear and convincing

evidence that Respondents Neuberger and Margolis & Co. arranged for an extension of credit to their customers in violation of Section 11(d) and Section 7(c) (1) and (2) of the 1934 Act. Respondents Neuberger and Margolis & Co. contended, however, that they had not "arranged" credit under the law of Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152 (8th Cir. 1977) ['77-'78 Sec. L. Rep. (CCH) paragraph 96,152]. In Shull, Dain's branch manager drove a customer to the bank and introduced him to a bank officer. The branch manager did not make an appointment for the customer and did not encourage the banker to make the loan. The trial court found no "arranging". The Eighth Circuit expressed the opinion that the decision of the trial court could have gone the other way, but that it could not be said to be "clearly erroneous'. The Eighth Circuit mentioned a "but for" test ("but for" the efforts of the broker, the loan would not have been made) as one extreme view of the interpretation of the phrase, "arranging credit". The court went on, however, to cite approvingly the approach of Alaska Interstate Co. v. McMillian, 402 F.Supp. 532, 553-58 (D. Del. 1975) where the court held that whether credit was arranged depends upon the degree of the broker's participation and his propensity to cause an extension of credit in a situation where credit might not otherwise be extended.

The Securities Division cites the case of In the Matter of Sutro Brothers and Co., '61-'64 Sec. L. Rep. (CCH) paragraph 76,913, a 1963 decision of the S.E.C. wherein the Commission said at page 81,388:

> But we think it clear that when a broker permits himself to become the intermediary between customer and factor with respect to the customer's account or dealings with the factor, as by conveying the customer's communications or instructions to the factor or by responding to requests or directives of the factor concerning the customer's transactions, the broker becomes so involved in the extension or maintenance of credit for the customer by the lender as to be held to be arranging.

Perhaps most instructive is the case of A -J. White and Co. v. S.E.C., 556 F.2d 619 (lst Cir. 1977) ['77-'78 Sec. L. Rep. (CCH) paragraph 96,0871. In this case, a public offering of Develco stock was not going well. President White suggested at a meeting that money could be borrowed to buy the stock and two Develco principals did borrow $18,000 which was then given to two Develco employees who then purchased stock from the offering on the understanding that it would be resold shortly to pay off the loans. An additional $70,000 was also borrowed for six customers of A. J. White to purchase stock from the offering. President White was the overall supervisor of the firm and participated in the underwriting. The court found a violation of both Section 7(c) and Section 11(d)(1) on the part of the broker and cited the Sutro Brothers and Co. case.

Even under a stricter "but for" test, it is clear that Neuberger and therefore Margolis & Co. arranged credit for customers Locktu and Campbell. Neuberger initially contacted the lender to check on the availability of funds and then solicited the purchases of Fey stock from his customers while advising them they could borrow money for the purchase through the lender he had already contacted. Neuberger was the intermediary between the lender and his customers and handled all the details of the loan transaction on behalf of his customers. Locktu and Campbell never even visited the bank or talked to anyone at the bank. Neuberger even apparently went so far as to create inaccurate financial statements and forged promissory notes in regard to the loan transaction. When the promissory notes came due, Neuberger handled all the details on behalf of his clients in regard to obtaining extensions of the loans.

It is concluded that the evidence is insufficient to determine that Respondent McLaughlin 'arranged credit" in regard to customers Locktu and Campbell. It is true that Neuberger discussed with McLaughlin the possibility of financing the purchase of Fey stock and that McLaughlin introduced

Neuberger to the bank official, Lewis Anderson. There is no convincing evidence, however, which would link Anderson to any of the subsequent events concerning the Locktu and Campbell loans. McLaughlin did receive the commission on the sale of Fey stock to Locktu and Campbell, however, any inference which might be drawn from that fact would require further evidentiary support in order to amount to clear and convincing evidence.

The Securities Division also alleges that Respondent McLaughlin's arrangement of credit for himself in order to purchase the 7,000 shares of Fey for Anderson's account constitutes a violation of the credit provisions previously discussed. The Respondents have noted that the statutes speak in terms of "arranging credit to or for a customer" and therefore does not seem to apply to a securities salesman arranging credit on his own behalf. The Securities Division cites the Sutro case, at page 81,385 for the proposition that a salesman arranging credit on his own behalf in order to purchase securities violates the credit provisions. While this 1963 S.E.C. decision is correctly interpreted by the Securities Division, it would seem to contravene the express language of the statute. In a case such as the case at bar (and especially where the factual situation surrounding McLaughlin's loans to purchase Fey stock for Anderson's account is also more directly the subject matter of other alleged violations of statute and rule) it appears unwise to conclude that there is a violation of the credit provisions based only upon the authority of the Sutro case.

McLaughlin and Neuberger's conduct plainly violated the language of Rule lOb-6 since they purchased Fey stock for accounts in which they had a beneficial interest while Fey was the subject of a distribution. Respondent McLaughlin contended that he did not purchase the Fey stock since there was no parting of value for the stock and in that he had no beneficial interest since he did not have the ability to exercise a controlling influence over the purchase or sale of the stock. The

record indicates, however, that McLaughlin's loan proceeds paid for the 7,000 shares of Fey stock and that, when McLaughlin wished to be rid of the obligation, he was able to transfer it to Neuberger and to eventually transfer the stock from Anderson's account to Campbell's account. Likewise, Neuberger had a beneficial interest in Campbell's account since he signed the note financing the purchase, placed the shares in Campbell's account, and sold the shares out of Campbell's account and paid off the loan on his own authority.

The conduct by Respondents Neuberger and McLaughlin created an appearance of a demand for the Fey stock which was not in fact justified. This type of manipulation was one of the causes for the enactment of Section 10(b) and Rule lOb-6. S.E.C. v. Scott_Taylor and Co., Inc.,183 F.Supp. 904, 907 (S.D.N.Y. 1959).

The placing of shares of stock from a distribution into controlled accounts, commonly called "parking", is a fraud upon members of the public and violates the anti-fraud provisions set out in Conclusions No. 29 through 32. The case of In the Matter of H. Hentz and Co., '69-'70 Sec. L. Rep. (CCH) paragraph77,853 [S.E.C. Securities Exchange Act release No. 8973, September 2, 1970] involved a broker-dealer who was suspended because the broker-dealer had withheld from public sale a number of shares of stock and placed them with officers and other associates of the issuer. The S.E.C. found this to be a violation of Sections 17(a) and 10(b) and Rule lOb-5, and observed that the broker-dealer had violated its duty to make a public offering.

The use of false and misleading statements in an offering circular concerning the stock which is the subject of a distribution has been held to be fraudulent in the case of Batten and Co., Inc. v. S.E.C., 345 F.2d 82 (D.C. Cir. 1964). In the Batten case, Batten and Co. retained control over approximately

10,000 shares out of 106,875 by recording them as sold to relatives, employees and friends and then repurchasing them shortly after the date upon which the offering was completed. The court found violations of Section 17(a) of the 1933 Act and Section 10(b) and Rule lOb-5.

The First Circuit in the A. J. White and Co. case, supra, also found violations of the same statutes and rules for a failure to disclose the existence of controlled accounts in the offering circular. The court stated as follows:

> Our question, therefore, is whether it matters significantly to investors that about one-half of the minimum amount was raised through short term bank loans rather than bona fide sales to investors. . . The knowledge that the minimum amount has been sold to bona fide investors may be a very important matter to the other investors. Particularly in cases such as this, an offering of shares in a new company, one of the investors major concerns will be whether the price they are paying for the securities is a fair market price. The inability of the underwriter to sell the specified minimum to bona fide investors may well indicate that the market judges the offering price to be too high. Thus, to declare an offering completed through non-bona fide sales financed through bank loans, where the purported investors have not made an investment decision backed with their own money, may significantly mislead the legitimate investors as to a crucial factor in their decision. ('77-'78 Sec. L. Rep. (CCH) at p. 91,917)

In replying to the Respondents' claim that it was too late to disclose the controlled accounts, the White court stated that the investors had a right to assume that the prospectus would be complied with if it could not be changed.

The case of Kavit v. A. L. Stamm & Co. and Levien, '66-'67 Sec. L. Rep. (CCH) paragraph 91,915 (S.D.N.Y. 1967), stands for the proposition that unauthorized purchases or sales in a customer's account are potential violations of Section 10(b) of the 1934

Act and Rule lOb-5. See also, Armstrong, Jones & Co. v. S.E.C., 421 F.2d 359 (6th Cir. 1970). The evidence is uncontradicted that McLaughlin purchased the 7,000 shares of Fey for Anderson's account without his authorization. The Securities Division also claims that Chase violated the same rule of law, however, it appears that in his case the customer, Reger, was aware of and authorized the purchase as long as Reger did not have to

Supply any funds for the transaction.

The Division has suggested that the series of events by which Margolis & Co. reintroduced the parked shares into the market from the accounts of Campbell and Locktu at increasing prices from $3 to $4 per share was a manipulative device on the theory that if all of the parked shares had been introduced into the market at one time there most likely would have been no increase in the value of the Fey stock. It is concluded that the evidence in this record is insufficient to support this contention. Although it is not Determinative, there was no direct testimony concerning such a scheme. It would appear that the primary goal of Margolis & Co. was to sell the parked stock as soon as they could consistent with the goal of selling it in excess of the offering price so as to avoid any loss. It is not necessarily clear that the introduction of the parked shares would have depressed the market price based on this record. Generally, a manipulative purpose must be shown in order to prove a violation. S.E.C. v. Andrews, 1 SEC Jud. Dec. 265.

While the record contains no direct evidence that President Neuberger was aware of the McLaughlin-Anderson transaction when it was first initiated or that he was aware of the Chase-Reger transaction, (although it is hard to understand how he could have been unaware of these matters as supervisor of the Fey underwriting) it is clear that President Neuberger's conduct and Compliance Officer Chase's conduct set the standard for compliance at the firm. McLaughlin was certainly aware of Neuberger's attitude since Neuberger discussed financing of Fey stock with McLaughlin and also assumed McLaughlin's loan in regard to the shares of Fey stock in Anderson's account.

The record is insufficient to prove that the Chairman of the firm, Sam Margolis, failed to reasonably supervise. The evidence concerning Margolis was essentially limited to Neuberger's non-specific testimony that Sam Margolis was aware of the Locktu

and Campbell loans when they were made, and that he (Neuberger) talked to Sam Margolis about the Fey underwriting. Mr. Margolis was not called as a witness in the case and the record is barren as to the extent of his knowledge about the activities of Neuberger, Chase and McLaughlin.

C.A.B.